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Stability Contributions
Their effects on bank funding and money supply

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June 2016
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Final project for BS degree in Economics
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This thesis is a 12 ECTS credit final project for a BS degree at the Faculty of Economics, School of Social Sciences, University of Iceland.

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Preface

This thesis is a 12 ECTS credit final project for a BS degree at the Faculty of Economics at the School of Social Sciences of the University of Iceland. My instructor for this thesis is Dr. Hersir Sigurgeirsson, Associate Professor at the Faculty of Business Administration, and I thank him for his guidance and advice during the writing process. My supervisor for this thesis is Dr. Ásgeir Jónsson, Associate Professor at the Faculty of Economics and I thank him for his insightful comments. I also wish to thank my father, Snorri Valsson, and my brother, Tómas Örn, for their help in proofreading the thesis and my fiancé, Ragna Björk Bernburg, for her help and support.
Abstract

On June 8, 2015 the Central Bank and the Ministry of Finance proposed that the estates of the collapsed Icelandic commercial banks would receive an exemption from the Foreign Exchange Act to pay their creditors by either meeting certain stability conditions through their composition agreements or by paying a special 39% stability tax on all of their domestic assets. In order to meet the stability conditions the estates were required to transfer various assets to the Icelandic government and reconstruct loan agreements with their new counterparts, the currently operating banks.

This paper analyzes these stability contributions and the effects they might have on the Icelandic economy. Firstly, the effects on the funding of the new banks is examined but the estates held equity, bonds and deposits in vast amounts in the Icelandic banking system. Secondly, the possible effects on the money supply due to the contributions are discussed but a large increase in the money stock before the financial crisis still resides in the system.

The total magnitude of the contributions, both direct and indirect, is estimated at 591 billion ISK or 26.8% of Iceland’s GDP. Additionally, due to the lengthening of loan agreements and the domestic reserves held by the estates, the total mitigating actions taken by the estates amount to 887 billion ISK or 40.2% of Iceland’s GDP. The average funding cost of the banks will increase, at least for the short term, because of the amount of deposits held by the estates which were converted into bonds but the possibility of a better credit rating might offset the increase in the future. The immediate changes in the banks’ funding offers new possibilities in increased lending operations due to the longer maturity of their liabilities.

It is estimated that the government has a chance to decrease the money supply by as much as 700 billion ISK through the stability contributions and other events related to the winding up of the estates. That means that the money supply as a percentage of the GDP can be reduced from 78% to 43%. However, the ultimate change in the money supply will rely on how the government allocates the funds it receives, such as whether it reduces its debt or increases government expenses.
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1 Introduction

In the summer of 2008, only several months before the turmoil in the world’s financial markets would come crashing over Iceland, the total size of the three large commercial banks amounted to roughly 14 thousand billion ISK, which at the time was about nine times greater than the GDP of Iceland (Jónsson and Sigurgeirsson, 2015; Statistics Iceland, 2016). The size of the banking system in Iceland had been increased in the years before, mainly by borrowing through foreign bond markets. The banks had also begun collecting foreign deposits, either through their branches abroad or foreign subsidiaries. Due to the size of the banks and their dependence on foreign currency to meet their obligations, the Central Bank of Iceland did not possess the ability to save them from collapsing when international interbank lending markets dried up (Hreinsson, Gunnarsson and Benediktsdottir, 2010).

On October 6, 2008 the Parliament of Iceland passed an act that came to be known as the Icelandic Emergency Act, which allowed the Icelandic Financial Supervisory Authority (FME) to step in and seize control of financial institutions on the brink of bankruptcy (Parliament of Iceland, 2008). The act also stated that deposits would be ranked as priority claims and therefore changed the claim order on the banks. The FME, working in accordance with the Emergency Act, took over control of Glitnir, Kaupthing and Landsbanki Íslands (LBI) in the following week and subsequently transferred their domestic assets and liabilities to new entities, which would later become Íslandsbanki, Arion Bank and Landsbankinn.

The Icelandic economy had also become an attractive setting for investors to practice carry trade, since nominal interest rates in Iceland were much higher prior to the financial crisis than in many Western countries. The magnitude of this carry trade at the time of the collapse of the Icelandic banks was around 650 billion ISK or roughly 40% of the GDP at the time. Due to the nature of carry trade, most of the foreign capital was in short term assets which could easily be liquidated and transferred out of the country with ensuing pressure on the domestic currency. The estates of the old banks posed a threat to
Iceland’s financial stability in a similar way due to the fact that they would seek to liquidize assets and pay their creditors as soon as possible.

Iceland is a small nation, with a small economy and its own small currency, the Icelandic Krona (ISK). This means that a bank crisis, such as the financial crisis in 2008 and the following recession, will also lead to a currency crisis when investors, both foreign and domestic, pour into the currency market to sell their ISK assets. Countries with larger currencies can react to these kinds of crises by printing money in order to stimulate the economy but in a small economy like Iceland the additional money would flow just as fast out of the country through the currency markets. Therefore, to protect the Icelandic Krona, the government imposed capital controls following the collapse. Those restrictions are still in effect at the time of this writing (Jónsson and Sigurgeirsson, 2015).

If the government intended to rid the economy of the capital controls it not only had to deal with these two different types of foreign investors who would leave as soon as the restrictions were lifted but also the domestic need for investing abroad in order to diversify asset portfolios. The basics of the threat posed by these three different entities are the same but the solutions are not. The actions taken by the government to set the carry trade investors and the domestic investors free from the capital controls will not be discussed further in this paper. It will instead focus on the solution to the problem posed by the estates.

The government was essentially faced with two different paths it could take in order to minimize the risk caused by the winding up of the estates. The first option was to allow the estates to vote on their composition agreements but, it was clear that the estates could not pay their creditors without first getting their composition agreements accepted by the Central Bank of Iceland and the Ministry of Finance. This option would have given the government the opportunity to condition the composition agreements but, the estates would not have been forced to come to the table, possibly creating holdouts.

Since the winding up of the estates was a step towards lifting the capital controls it was necessary to eliminate the possibility of holdouts, meaning that any action taken by the government had to cover all estates. Otherwise, the government risked possible obligations to these holdouts which might have threatened the financial stability of the country. The risk of holdouts could have been eliminated with taxation but that kind of
tax might have been challenged in the courts, further delaying the winding up of the estates.

The second possibility for the government was to force the estates into bankruptcy which would mean the creditors would lose their control of the estates’ management. The option of driving the estates to bankruptcy was popular among certain groups in Iceland because people believed that due to Icelandic law the estates would be forced to hand over all foreign assets to the government and pay out their claims in ISK. This view was however put to rest in 2014 when the Icelandic Supreme Court ruled that a bankrupt estate is only required to calculate its claims in ISK but can repay its claims in any currency that fits the estate’s needs. The Icelandic government lost some leverage it was thought to have prior to that ruling and the bankruptcy option was effectively off the table (Jónsson and Sigurgeirsson, 2015).

On June 8, 2015 the Central Bank and the Ministry of Finance proposed that the estates would receive an exemption from the Foreign Exchange Act by either meeting certain stability conditions through their composition agreements or by paying a special 39% stability tax on all of their domestic assets (Parliament of Iceland, 2015). The conditions set forth by the Central Bank and the Ministry of Finance in that proposal were the following:

➢ To adopt measures that sufficiently reduce the negative impact of distributing the proceeds of the sale of the assets in Icelandic Krona.

➢ To convert other foreign-denominated domestic assets owned by the failed banks into long-term financing to the degree required.

➢ Where applicable, to ensure the repayment of the foreign-denominated loan facilities granted by the authorities to the new banks following the financial market collapse.

By fulfilling these conditions through stability contributions, loan repayments and debt reconstructions, the estates would get their composition agreements confirmed before a specific date and thus be exempt from the stability tax. If an estate would choose to pay the stability tax, the Central Bank and the Ministry of Finance would subsequently confirm that estate’s composition agreement and exempt it from the Foreign Exchange Act.

There were eight estates in all that would fall under the stability tax and all of them chose the option of meeting the stability contributions. One of the estates, ALMC, had
already confirmed their composition agreements but came to an agreement with the Central Bank to be exempt from the stability tax and to receive an exemption from the Foreign Exchange Act (CBI, 2015a).

The estates of the old commercial banks, Glitnir, Kaupthing and LBI, accounted for over 90% of the size of the problem and therefore their actions would be of most importance. This paper will focus on the actions taken by those estates and the effects on the funding of their new counterparts, Íslandsbanki, Arion Bank and Landsbankinn. The possible effects of the contributions on the money supply will also be discussed.

In chapter two the stability contributions of the three large estates are analyzed in detail, with additional analysis of the five smaller estates. Finally, the total magnitude of the contributions and other mitigating actions are summarized and compared to the Icelandic GDP from 2015.

In chapter three the reconstruction of the fallen commercial banks is examined and the changes in their funding composition are analyzed. Furthermore, the effects on the banks’ funding due to the stability contributions is summarized for each bank separately.

Chapter four will focus on the effects on the money supply due to the stability contributions. The chapter is a brief discussion on the matter but the final outcome will always depend on the allocation of the funds acquired by the government through this process.

In chapter five the main conclusions are drawn from the paper and the effects of the winding up of the estates are evaluated as a whole.
2 Stability contributions and other mitigating actions

In a report issued in October 2015 the Central Bank of Iceland and the Ministry of Finance estimated the total size of the estates’ assets, specifically assets posing a threat to Iceland’s balance of payments and financial stability, to be 816 billion ISK (MoF, 2015a). The stability contributions dealt with this problem in many ways, not only by direct contributions but also with different kinds of debt and equity modification.

![Figure 1: Total stability contributions](image)

Figure 1: Total size of the stability contributions of the three largest banks. Source: Ministry of Finance, 2015a.

In Figure 1 the blue column on the left represents the total size of the problem, 816 billion ISK. That is all domestic assets, both in ISK and foreign currency, which the estates hold. All the other columns in the picture show what mitigating actions were taken to meet the stability conditions. The largest one was the direct contribution of assets, a total of 261 billion ISK, from the estates to the government. The biggest factor there is the transfer of Glitnir’s stake in Íslandsbanki to the Icelandic government, which is further discussed later in this chapter.

The second largest mitigating action was the modification of the banks’ loan structure, which amounted to 226 billion ISK. The winding-up boards agreed to convert their short term foreign currency deposits in the banks into standard international long-term bond funding (CBI, 2015b). In addition to the deposits, these bond issues covered the amount needed to reimburse the Treasury and the Central Bank for the loans made by the
government during the establishment of the new banks. The third and fourth largest actions were, respectively, the special agreement between the government and Kaupthing concerning the sale of Arion Bank, amounting to 104 billion ISK and the Central Bank’s recoveries, 81 billion ISK, through its holding company, Central Bank of Iceland Holding Company ehf (ESÍ).

A total of 57 billion ISK in reserves and foreign assets were held by the estates but these amounts are supposed to cover the cost of a variety of unresolved obligations. If those costs are not realized the amounts will be transferred to the Treasury. Taxes paid by the estates of the fallen banks for the year 2015 were in total 30 billion ISK (CBI, 2015b; MoF, 2015a). Risk from disputes concerning the legitimacy of certain taxes levied on the banks was eliminated with cash sweep provisions. Other smaller contributions were contingent bonds and adjustments for foreign assets.

The net capital outflow due to the winding up of the estates is estimated to amount to 28 billion ISK, meaning that it will have an effect of negative that amount on the foreign reserves at the Central Bank. To put that into perspective with the Central Bank’s ability to manage the flow, the net currency reserves (currency reserves financed with ISK-denominated debt) were around 200 billion ISK in year-end 2015. The total effect on the reserve will however be positive by 41 billion ISK despite the net capital outflow of 28 billion ISK. This is because the estates agreed to reimburse foreign denominated debt which the government granted the new banks after the financial crisis (CBI, 2015b).
2.1 Kaupthing’s stability contributions and mitigating actions

Figure 2: Total size of Kaupthing’s stability contributions. Source: Ministry of Finance, 2015a.

Kaupthing’s part of the stability contributions is shown in Figure 2 and the blue column on the left depicts its total domestic assets, both in ISK and FX. Kaupthing’s largest contribution was the bond issue to the government for 84 billion ISK. The issue is in the form of a collateralized bond which stipulates that the principal payment must be generated from the sale of Arion Bank. The collateral of the bond is both in the form of bonds issued by Arion Bank to the Kaupthing estate and Kaupthing’s stake in Kaupskil ehf., which holds its shares in Arion Bank.

On top of that the government has made a profit-sharing agreement with Kaupthing which minimizes the risk from the sale of Arion Bank to Iceland’s balance of payments. If the bank will be sold at book value, which was around 152 billion ISK in 2015, the government’s share will be worth 20 billion ISK, making the total contribution amount to 104 billion ISK\(^1\). Enclosed in this profit-sharing agreement was also an arrangement to

\[^1\] If the selling price is above 100 billion ISK the government will get a share of the increase in price and its share grows as the price increases. The government will receive a third of the increase in selling price over 100 billion ISK if the price is between 100 and 140 billion ISK, half of the amount between 140 and 160 billion ISK, and three quarters of the amount above 160 billion ISK. (Settlement of the failed financial institutions – Central Bank of Iceland – p. 12)
share the possible future dividends between Kaupthing and the government. The sale of Arion Bank is therefore estimated to deliver around 104 billion ISK to the Icelandic government, but that amount may change depending on dividend payouts and final selling price.

Other transferred assets from Kaupthing include funds and assets for 4 billion ISK, assets denominated in foreign currency for 14 billion ISK and cash sweep assets, which were for some reason not transferrable, for 6 billion ISK. Those amounts were all marked on book value but the nominal value of these assets was much higher or 75 billion, 42 billion and 295 billion ISK respectively (MoF, 2015a). These assets were transferred to the government to eliminate the risk that an increase in their value could pose to the balance of payments. The cash sweeps were used for assets that are not transferrable, for example because of some legal dispute. When the value of these assets is realized the total amount will be transferred to the government.

In addition to these contributions Kaupthing agreed to convert its foreign currency deposits held by Arion Bank and the Central Bank, a total of 42 billion ISK, to a longer term bond issue. The bond issue was also used to pay back a foreign denominated loan from the Central Bank from 2010 but that loan was only payable in Euros. Arion Bank issued a bond under its EMTN program, for a total amount equivalent to 97 billion ISK, to Kaupthing, which paid for it with its deposits and an equivalent amount to 54 billion ISK in Euros that it delivered to the Central Bank.

Kaupthing maintained reserves for a total of 7 billion ISK to meet unrealized costs. If these costs end up being lower than previously estimated the difference will be delivered to the government. Included in the total mitigating actions were the estates’ taxes for the year 2015 but Kaupthing paid 12 billion ISK in taxes.

The Central Bank of Iceland Holding Company (ESÍ) will receive 40 billion ISK in foreign currency for its claims on Kaupthing in the next few years but the estate instead receives an allowance to convert ISK assets to currency. The net capital flow from winding up the Kaupthing estate will therefore be negative 5 billion ISK meaning that it yields a positive effect on the Central Bank’s currency holdings. In addition the Central Bank received a payment from Kaupthing for Arion Bank’s bond issue in Euros equivalent to 54 billion ISK but Kaupthing also withdrew 5 billion ISK deposit from the Central Bank and delivered it
to Arion Bank. The total impact of Kaupthing’s settlement on the Central Bank’s reserves will accordingly be positive in the amount of 55 billion ISK (MoF, 2015a).

The total magnitude of the actions taken by the Kaupthing estate in the winding up process is 251 billion ISK but in order to analyze the effects on the economy it is important to distinguish between the direct and indirect contributions. Kaupthing’s direct contributions to the Icelandic government are estimated to be around 128 billion ISK, its indirect contributions around 52 billion ISK, the funds the estate holds for future domestic expenses is 29 billion ISK and the lengthening of its deposits at Arion Bank around 42 billion ISK.

2.2 Glitnir’s stability contributions and mitigating actions

![Glitnir's stability contributions](image)

**Figure 3: Total size of Glitnir’s stability contributions. Source: Ministry of Finance, 2015a.**

Glitnir is the estate that held the largest share of domestic assets and therefore had to pay the highest amount in ISK to fulfil the stability conditions. On October 20, 2015 Glitnir announced its plans to meet the conditions by transferring all its stake in Íslandsbanki to the Icelandic government. Glitnir transferred its subsidiary ISB Holding to the government, but ISB Holding owned a 95% stake in Íslandsbanki. This transaction was estimated at 185 billion ISK on book value which made it the largest contribution from Glitnir. Before this decision was made Glitnir planned to meet its obligations in a similar way as Kaupthing did but that arrangement fell through because the estate could not...
come to an agreement with the government on the full amount of contributions (MoF, 2015b).

Other transferred liquid funds and assets were estimated on book value to be 37 billion ISK but their nominal value is 85 billion ISK. Additionally Glitnir assigned cash sweep provisions to certain assets for a total 7 billion ISK on book value but 46 billion ISK on nominal value. To secure Íslandsbanki foreign funding Glitnir converted its foreign currency deposits, which the bank held, to a longer term internationally recognized bond issue in the amount equivalent to 35 billion ISK.

On top of that Glitnir purchased a subordinated bond for 20 billion ISK from the Treasury, paid with foreign currency. The Treasury bought the bond issue from Íslandsbanki for ISK but the bond stipulates that the principal is only payable in foreign currency (CBI, 2015b). Glitnir held reserves for a total of 22 billion ISK to meet unrealized costs. If these costs end up being lower than previously estimated the difference will be delivered to the government. Glitnir paid 11 billion ISK in taxes for the year 2015.

The net capital flow caused by the settlement of the Glitnir estate is positive 48 billion ISK. Glitnir is allowed to exchange 72 billion ISK for foreign currency because of the transfer of Íslandsbanki to the government. In addition to transferring its share in Íslandsbanki, Glitnir agreed to forgo a dividend payment for 16 billion ISK and made other agreements, which enabled it to hold on to more liquid assets than the other estates. The Central Bank will receive the equivalent of 20 billion ISK in foreign currency from Glitnir for the bond issued by Íslandsbanki. Adding to this the estimated currency equivalent to 24 billion ISK in ESÍ claims on Glitnir, the total impact of Glitnir’s settlement on the Central Bank’s reserves will accordingly be negative 28 billion ISK.

The total magnitude of Glitnir’s actions was 336 billion ISK but it is important to distinguish between the different ways it affects the economy. Glitnir’s direct contributions to the Icelandic government were estimated to be around 229 billion ISK, its indirect contributions around 38 billion ISK, the conversion of its deposits around 35 billion ISK and other actions 34 billion ISK.
2.3 LBI’s stability contributions and mitigating actions

![Figure 4: Total size of LBI’s stability contributions. Source: Ministry of Finance, 2015a.](image)

In late 2014 Landsbankinn and LBI made an agreement about extending Landsbankinn’s bond obligations to LBI. The old bond between them had a maturity date in October 2018 with just under 240 billion ISK outstanding in the beginning of 2014. The old bond was issued in Euros, Dollars and Pounds sterling and had annual principal payments. The new issue was also in Euros, Dollars and Pounds sterling but it was split up into 10 separate bonds with different sizes and maturities; 3 bonds in 2016, 3 bonds in 2018, 1 bond in 2020, 2022, 2024 and 2026. The outstanding amount on the issue is around 190 billion ISK in year-end 2015 since Landsbankinn has already prepaid a share of it for 40 billion ISK.

Therefore the amount which falls under the stability conditions is around 150 billion ISK². By converting the old bond to a longer term bond in 2014, LBI had already met the condition focusing on securing the banks foreign financing. The old bond was secured by liquid foreign assets in Landsbankinn and so is the new bond. As a part of the agreement LBI granted Landsbankinn the right to convert the current issue to an unsecured issue

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² The bank purchased 25 billion ISK worth of the bond back before year-end 2015, making the total balance 125 billion ISK.
under the bank’s EMTN program. This would give the bank more flexibility since it would not have to hold so much collateral against the bond.

LBI transferred assets to the government for 20 billion ISK, thereof 3 billion ISK in liquid assets. The nominal value of the transferred assets was 90 billion ISK. LBI also assigned cash sweep provisions to assets with a book value of 3 billion ISK but with a nominal value of 172 billion ISK. The Central Bank of Iceland Holding Company will recover 14 billion ISK over the next few years from LBI because of claims it has on the estate. Reserve funds to meet operating costs or some unexpected costs were in total 6 billion ISK and LBI paid 8 billion ISK in taxes for the year 2015.

The net capital flow caused by the settlement of the LBI estate is estimated to be negative 15 billion ISK. LBI will therefore contribute the equivalent of 15 billion ISK in foreign currency to the Central Bank reserve through the claims on the estate held by ESÍ. The total magnitude of LBI’s actions taken to fulfil the stability conditions was 200 billion ISK, with the lengthening of the bond amounting to three quarters of that or 149 billion ISK. Direct contributions amounted to 23 billion ISK, indirect contributions to 22 billion ISK and other actions, such as reserves, amounted to 6 billion ISK.

2.4 Summary of the contributions

In order to estimate the effects of the stability contributions on the economy it is necessary to differentiate between the direct contributions, indirect contributions and other actions. The breakdown of the contributions is shown in Table 1 along with each amount as a portion of Iceland’s 2015 GDP. Direct contributions from the three estates combined amounted to 380 billion ISK or 17.2% of Iceland’s 2015 GDP. The largest two assets in that category were Glitnir’s share in Íslandsbanki and Kaupthing’s bond issue to the government, totaling 324 billion ISK. Other assets included shares in Icelandic companies, cash, bonds and assets bound by cash sweep provisions.

The indirect contributions, totaling 186 billion ISK, consisted of three different contributions that would have been delivered to the government at some point without the agreement it made with the estates. Firstly, were the claims held by the Central Bank of Iceland Holding Company (ESÍ) on the estates, amounting to 81 billion ISK combined. ESÍ will recover these funds over the next few years but the amount was independent of the agreements considering the winding up of the estates. Secondly, the estates of Glitnir
and Kaupthing purchased bonds held by government agencies for a total of 74 billion ISK in foreign currency. Kaupthing purchased Arion Bank’s bond from the Central Bank for 54 billion ISK and Glitnir purchased a subordinated Íslandsbanki bond from the Treasury for 20 billion ISK. Thirdly, the 31 billion ISK in taxes paid by the estates for the year 2015 which clearly would have been delivered to the government, regardless of the conditions and the contributions. Both the direct and indirect contributions have already ended up or will end up with the government, which means that the Treasury will receive assets amounting to 566 billion ISK or the equivalent to 25.6% of the country’s 2015 GDP.

Other mitigating actions included the lengthening of debt, reserves held by the estates and the adjustment for the foreign assets the estates delivered to the Treasury. The total amount was 296 billion ISK but 226 billion ISK of that amount was due to the lengthening of debt held by the new banks. Reserve funds held by the estates to meet its domestic obligations in the coming years amounted to 57 billion ISK but if those costs are not realized at a certain time the funds will be delivered to the Treasury.

Table 1: Total contributions and other mitigating actions taken by the three estates. Source: CBI, 2015b.

<table>
<thead>
<tr>
<th>Amounts in ISK billions</th>
<th>Kaupthing</th>
<th>Glitnir</th>
<th>LBI</th>
<th>Total</th>
<th>% of GDP</th>
</tr>
</thead>
<tbody>
<tr>
<td>Direct contributions to the government</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Measures vis-á-vis Arion</td>
<td>104</td>
<td>104</td>
<td></td>
<td></td>
<td>4.7%</td>
</tr>
<tr>
<td>Transferred assets</td>
<td>18</td>
<td>222</td>
<td>20</td>
<td>260</td>
<td>11.8%</td>
</tr>
<tr>
<td>Cash sweep provisions</td>
<td>6</td>
<td>7</td>
<td>3</td>
<td>16</td>
<td>0.7%</td>
</tr>
<tr>
<td>Total</td>
<td>128</td>
<td>229</td>
<td>23</td>
<td>380</td>
<td>17.2%</td>
</tr>
<tr>
<td>Indirect contributions to the government</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>ESÍ recoveries</td>
<td>40</td>
<td>27</td>
<td>14</td>
<td>81</td>
<td>3.7%</td>
</tr>
<tr>
<td>Taxes</td>
<td>12</td>
<td>11</td>
<td>8</td>
<td>31</td>
<td>1.4%</td>
</tr>
<tr>
<td>Repayments</td>
<td>54</td>
<td>20</td>
<td>0</td>
<td>74</td>
<td>3.4%</td>
</tr>
<tr>
<td>Total</td>
<td>106</td>
<td>58</td>
<td>22</td>
<td>186</td>
<td>8.4%</td>
</tr>
<tr>
<td>Other mitigating actions</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Long-term financing</td>
<td>42</td>
<td>35</td>
<td>149</td>
<td>226</td>
<td>10.2%</td>
</tr>
<tr>
<td>Adjusted for foreign assets</td>
<td>1</td>
<td>12</td>
<td></td>
<td>13</td>
<td>0.6%</td>
</tr>
<tr>
<td>Reserve fund</td>
<td>29</td>
<td>22</td>
<td>6</td>
<td>57</td>
<td>2.6%</td>
</tr>
<tr>
<td>Total</td>
<td>72</td>
<td>69</td>
<td>155</td>
<td>296</td>
<td>13.4%</td>
</tr>
<tr>
<td>Total mitigating actions of the estates</td>
<td>306</td>
<td>356</td>
<td>200</td>
<td>862</td>
<td>39.1%</td>
</tr>
<tr>
<td>As a percentage of Iceland GDP (2015)</td>
<td>13.9%</td>
<td>16.1%</td>
<td>9.1%</td>
<td>39.1%</td>
<td></td>
</tr>
<tr>
<td>Net capital flow due to estates</td>
<td>-5</td>
<td>48</td>
<td>-15</td>
<td>28</td>
<td>1.3%</td>
</tr>
</tbody>
</table>

21
2.5 Other estates

In the years leading up to 2008 there were several financial institutions with active operations in Iceland but most of them succumbed to the financial crash. The three largest banks were Kaupthing, Glitnir and Landsbankinn, which have been mentioned earlier in this chapter, but there were other relatively large institutions that went bust. The ultimatum introduced by the government to the estates of fallen financial institutions meant that there were eight estates which would either have to pay the stability tax or come to an agreement with the Central Bank and the Treasury. All the estates chose to work with the government to evade the taxation but only seven of them required exemptions from the capital controls to initiate payments to creditors (CBI, 2016d).

The scale of contributions from the three largest banks was much greater than that of the other five estates. These other estates are ALMC (former Straumur-Burðarás), BYR, EA Investments (former MP Bank), SPB (former Icicbank) and SPRON. In a report issued by the Central Bank the total assets of these estates were estimated at 172 billion ISK, thereof 107 billion ISK in foreign assets abroad and 22 billion ISK in domestic assets in foreign currency. The combined domestic ISK assets of the estates therefore amounted to 42 billion ISK but the total contributions from them were 7 billion ISK. In addition the Central Bank of Iceland Holding Company (ESÍ) will recover an equivalent amount to 18 billion ISK in foreign currency from the estates, making the combined direct and indirect contributions 25 billion ISK.

Four of the estates received an allowance to convert a total of 13 billion in ISK assets to foreign currency through the Central Bank. It is unknown what will happen to the remainder of the estates’ ISK assets, amounting to 22 billion ISK, but they might possibly be used to pay domestic creditors or held as reserves for future obligations (SPB hf., 2016).

Contributions from all eight estates, which would have fallen under the stability tax, are in total 591 billion ISK or the equivalent to 26.8% of Iceland’s 2015 GDP. Adding to that the lengthening of loans and reserves held by the estates, the total actions amount to 887 billion ISK or 40.2% of the 2015 GDP.
Table 2: Contributions from smaller estates and total contributions from all estates. Source: Central Bank of Iceland, 2015b.

<table>
<thead>
<tr>
<th>Amounts in ISK billions</th>
<th>Smaller estates</th>
<th>% of GDP</th>
</tr>
</thead>
<tbody>
<tr>
<td>Direct contributions to the government</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Transferred assets</td>
<td>7</td>
<td>0.3%</td>
</tr>
<tr>
<td>Indirect contributions to the government</td>
<td></td>
<td></td>
</tr>
<tr>
<td>ESÍ recoveries</td>
<td>18</td>
<td>0.8%</td>
</tr>
<tr>
<td>Total contributions of the smaller estates</td>
<td>25</td>
<td>1.1%</td>
</tr>
<tr>
<td>Total contributions of the larger three estates</td>
<td>566</td>
<td>25.7%</td>
</tr>
<tr>
<td>Total contributions of all estates</td>
<td>591</td>
<td>26.8%</td>
</tr>
</tbody>
</table>
3 What will be the effect on the banks’ funding?

The Icelandic Króna (ISK) was under capital controls for the lion’s share of the twentieth century or ever since the 1930’s. During this time Icelandic banks were mainly financed with domestic deposits and foreign syndicate loans. These syndicate loans were based on long term business association between the Icelandic, then state run banks and their European counterparts. The conditions for foreign funding changed dramatically in 1993 when the Icelandic government started lifting the capital controls and by the turn of the century the Icelandic banks had started issuing bonds in foreign markets.

In the years leading up to the financial crash of 2008 the big Icelandic banks, Kaupthing, Glitnir and Landsbankinn, relied heavily on foreign financing through these markets. In the years from 2004-2008 these three banks issued bonds on foreign markets for a total around 44 billion Euros (Hreinsson, Gunnarsson & Benediktsdóttir, 2010). To put that amount into perspective the GDP of Iceland in 2007 was around 15 billion Euros (CBI, 2016b; Statistics Iceland, 2016). In contrast the new banks comprise much more deposit funding than wholesale funding. Since the fall of the old banks in 2008 Icelandic enterprises have been limited in their ability to issue foreign denominated bonds due to both the lack of investor’s interest and low creditworthiness.

In this section we will look into how the stability contributions will affect the funding of the new banks and what opportunities might arise for future funding of the banks.

3.1 Arion Bank

Arion Bank, originally called New Kaupthing, was founded on the ruins of Kaupthing in the fall of 2008 by transferring all domestic assets and liabilities from Kaupthing to the new entity. In the years before, Kaupthing had grown extensively and in the first months of 2008 it was almost ten times larger, in nominal sense, than it was in 2004. It grew from around 560 billion ISK to roughly 5,300 billion ISK in four years. Most of that growth came from issuance of bonds in foreign markets and a lot of the loans on the bank’s books were made to foreign enterprises (Kaupthing, 2008). Therefore, when Arion Bank was formed around the domestic part it was considerably smaller with total assets amounting to roughly 640 billion ISK at year-end 2008 (Arion Bank, 2009).
Among the liabilities transferred from Kaupthing were roughly 420 billion ISK in customer deposits which constituted just under two-thirds of the bank’s total funding. Arion Bank’s liabilities due to other credit institutions and the Central Bank of Iceland were just over 120 billion ISK or 19% of its total funding. The Icelandic Government supplied the bank with equity of 72 billion ISK, with around 99% of that amount being paid with government bonds and the rest with cash (Arion Bank, 2009). However, the funding composition of Arion has changed considerably in the last seven years as shown in Figure 6.
The main change in Arion’s funding since it was established in 2008 is its increased borrowing. In 2009 Arion’s long term borrowing was almost non-existent, excluding a bond issue due to the acquisition of the savings and loans institution Sparisjóður Mýrasýslu (Arion Bank, 2010). The first major borrowing of Arion Bank came in 2010 when the bank took over and refinanced Kaupthing’s already matured debt due to the Central Bank. The new bond issue carried LIBOR rates with a premium of 300 bps (basis points) with a maturity date in 2022. The offsetting transaction was the transfer of a portion of Kaupthing’s loan portfolio, mainly its asset backed loans to municipalities and government owned companies, to Arion Bank (Arion Bank, 2011).

These kind of transfers continued in 2011 when Arion took over Kaupthing Mortgage Institutional Investor Fund (KMIIF), a special purpose vehicle for Kaupthing’s mortgage loans. This drastically increased Arion’s long term funding because the bond issues it took over alongside the loan portfolio amounted to around 118 billion ISK and had maturities between the years 2031 and 2048 (Arion Bank, 2012). At that time the bank’s funding consisted of 21% borrowing, a proportion which has increased slightly in the last years, as is shown in Figure 7. In 2015 Arion Bank issued uncollateralized bonds, both
denominated in Euros and in Norwegian Krone, for a total of over 55 billion ISK, resulting in a ratio of borrowing to total funding of 25.3% in year-end 2015.

![Arion Bank - Funding Composition - Proportional](image)

**Figure 7:** Arion Bank’s proportional funding composition from 2008 – 2015. Source: Arion Bank’s Consolidated Financial Statements, 2008 – 2015.

Customer deposits as a means of funding have stayed about the same, in a nominal sense, since the bank was founded, while deposits from the Central Bank and other credit institutions have changed substantially over the period. Customer deposits, as a proportion of the bank’s total funding, have however decreased steadily from 66% in 2008 down to 46% at year-end 2015. The proportional increase in long term borrowing, alongside proportional decrease in customer deposits, is a sign of the bank managing the maturity mismatch between its assets and liabilities.

Deposits due to the Central Bank and other credit institutions changed a lot around the capitalization of the bank, after the agreement between the Icelandic government and the Kaupthing estate. In addition the bank appears to have categorized deposits from credit institutions in winding-up process as customer deposits, since the amount which Kaupthing indicated it held as “cash at bank” was considerably larger than what Arion
Bank assigned to credit institutions. In its financial report for the first half of 2015 Kaupthing estimated its total cash at Icelandic banks to be over 48 billion ISK, the majority of which was in foreign currency or 44 billion ISK. This far exceeded the 11 billion in deposits which Arion Bank ascribed to the Central Bank and other credit institutions in its 2015 financial report (Arion Bank, 2016a).

Another factor of Arion’s funding composition that has changed is the equity base but, as was stated earlier, the Icelandic Treasury provided the bank’s starting capital. In January 2010 the Kaupthing estate acquired 87% of Arion’s share capital, with the Government holding the remaining 13%. Kaupthing agreed to provide up to 66 billion ISK in common equity of the 72 billion ISK the Treasury had promised, but not delivered, to Arion Bank. The Treasury agreed to offer Arion a foreign denominated, subordinated loan in the amount equivalent to 33 billion ISK, adding to the bank’s Tier II capital base (Minister of Finance, 2014-15).

After the change in ownership the bank’s Tier 1 capital accounted for 12% of total financing and with the subordinated Treasury loan the bank’s capital ratio was 16%. Arion has steadily increased these ratios since by retaining earnings but it have also repaid 20 billion ISK of the subordinated loan. At year-end 2015 the Tier 1 capital ratio was 22.3% and the capital adequacy ratio was 24.2% (Arion Bank, 2016a). The minimum capital adequacy ratio was 8% in 2015 but on January 1, 2016 a law came into effect allowing the Financial Supervisory Authority to increase the minimum, incrementally, to 10.5% on January 1, 2017 (Parliament of Iceland, 2016). Additionally, the Financial Stability Council at the Central Bank of Iceland made recommendations in January 2016 to the Financial Supervisory Authority (FME) to impose 6% capital buffers on the three big banks to prepare them for future outflow (CBI, 2016a). The minimum capital adequacy ratio could therefore be at least 16.5% in year-end 2016, but the FME has the authority to impose further requirements on the banks. Those additional requirements are not official but Arion Bank indicates in its 2015 financial statements that already it complies with all requirements set by the FME, including the new capital buffers.

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3 This argument relies on the assumption that Kaupthing holds all its domestic cash at Arion Bank and no other Icelandic bank.

Kaupthing’s stability contributions and other mitigating actions on its behalf will have some impact on Arion Bank’s funding. Kaupthing’s single largest contribution is its bond issue of 84 billion ISK to the government, payable only with proceeds from the sale of Arion bank, and the attached profit sharing agreement valued at 20 billion ISK in 2015. The bond issue itself will not affect Arion’s funding but the future sale of the bank will.

Another important action taken by Kaupthing to fulfil the stability conditions was its lengthening of Arion’s debt. Arion issued a Dollar denominated bond to Kaupthing in January 2016 in an amount equivalent to 97 billion ISK. The bond, which was issued under Arion’s EMTN-program, has a maturity of seven years but is callable on the interest paydays during the first two years. It carries a floating LIBOR rate with a premium of 260 bps for the first two years, at which point the premium will be renegotiated by taking into account Arion’s bond market terms.

Kaupthing’s offsetting transaction, as described in detail in the last chapter, consisted both of a payment through its deposits at Arion and the purchase of Arion’s debt at the Central Bank (Arion Bank, 2016b). This conversion will have a major effect on Arion’s funding composition. First, the bond issued to Kaupthing has a 40 bps lower premium than the bond which Arion issued to the Central Bank, therefore considerably lowering the interest cost of roughly 57.5 billion ISK, amounting to around 5.5% of its total funding (Kaupthing, 2015). Furthermore, the new bond is callable during the first two years, which
is a benefit for the issuer, and has a longer maturity than the old bond at the Central Bank. The fact that the bond is callable will be of value to Arion Bank if its credit premium lowers in the next two years. Arion’s secured debt ratio will also decrease from 24% to 18% due to fact that the bond being terminated was secured with various mortgages and loans to corporations, while the new issue under the bank’s EMTN program is unsecured (Arion Bank, 2016a).

The positive effect on Arion’s funding due to the purchase of its debt with the Central Bank is however at least evened out by the conversion of Kaupthing’s deposits into a long term bond. According to Kaupthing’s composition agreement the total amount converted from deposits is equivalent to 39.6 billion ISK in various currencies. The interest cost on those deposits will have ranged from as low as 0% up to around 1.5%, depending on the proportion of each currency of the whole 39.6 billion ISK (Arion Bank, 2016c). The added interest costs due to the conversion of the deposits to a bond will therefore amount to LIBOR interest rates with additional 110-260 bps. Considering that the one-year LIBOR rates are currently around 1.2%, the difference in interest is 2.3%-3.8% on the 39.6 billion ISK or a 0.9-1.5 billion ISK increase in interest payments a year.

Sometime in the next seven years the bond will be paid up in full with several billions in interest (how many depends on when the bond is paid) to Kaupthing. That means that at least roughly 100 billion ISK will flow out of the country after the bond is paid, given that Kaupthing will be able to convert the amount to foreign currency. The amount is just under one-tenth of Arion’s total size, making it likely that it will affect the bank’s financing considerably when the payment is made. The outflow of such an amount will also have an effect on the Central Bank’s reserves, the money supply and the Króna’s stability. This aspect of the stability contributions will be looked into in the last chapter and analyzed in more detail.

Furthermore, Kaupthing received an allowance to convert a total of 46 billion of ISK assets to foreign currency through the Central Bank. According to Kaupthing’s financial statement for 2015 the estate only held ISK assets for 11 billion after paying its stability contributions, excluding its 87% share in Arion Bank. Therefore, it is not certain when or how Kaupthing will take advantage of this permit to exchange ISK assets but might do so in relation to the sale of Arion Bank.
Other mitigating actions taken by the Kaupthing estate did not affect Arion Bank as much as the actions described above. These actions were the transferring of assets to the Treasury, both direct and through cash sweep provisions.

3.2 Íslandsbanki

In the weeks before the Icelandic banks collapsed, Glitnir had been seeking governmental assistance because its liquidity was deteriorating day by day. As stated in the report from the Special Investigation Commission, Glitnir was pursuing the possibility of a 600 million Euro loan from the appropriate lender of last resort, the Icelandic Central Bank. But Glitnir’s collateral was not adequate according to the Central Bank’s regulation, which instead offered a sort of a buy-in deal, one that priced Glitnir substantially under the market value at the time. Before the deal could be finalized by a vote at a shareholder meeting Glitnir had to ask for the assistance of the FME, the Icelandic Financial Supervisory Authority, which took over the board of directors.

Subsequently, the deal fell through as New Glitnir or Íslandsbanki, as it was later called, was founded around the domestic part of Glitnir’s banking business. Glitnir had a proportionately larger position in Iceland than Kaupthing which meant that Íslandsbanki was larger at its founding than Arion Bank even though Kaupthing was substantially larger than Glitnir at its fall. In year-end 2008 the total size of Íslandsbanki was 658 billion ISK and its funding at the time is shown in Figure 9.

![Íslandsbanki - Funding - 2008](image)

**Figure 9: Íslandsbanki’s funding in year-end 2008. Source: Íslandsbanki’s Consolidated Financial Statements, 2008.**

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Among the liabilities transferred from Glitnir were around 340 billion ISK in customer deposits which constituted just over half of the bank’s total funding. Íslandsbanki’s liabilities due to other credit institutions and the Central Bank of Iceland were roughly 155 billion ISK or just under a quarter of its total funding. The Icelandic Government supplied the bank with equity of 65 billion ISK, with 775 million ISK of that amount being paid in cash and roughly 64 billion ISK pledged and later paid with Governmental Bonds. However, since Íslandsbanki was founded the funding composition has changed in various ways as shown in Figure 10.

![Íslandsbanki - Funding Composition](image)


Ever since the bank was founded in 2008 it has relied heavily on deposits, both from customers and from other credit institutions, as a means of funding but at its founding these deposits combined accounted for 75% of the bank’s total funding. That ratio has decreased over the last seven years but it still stands at 59% at year-end 2015.

Even though the combined ratio of all deposits has decreased, the proportion of customer deposits has increased over the period. The single largest factor in that increase was Íslandsbanki’s merger with the domestic part of the savings and loans firm Byr Sparisjóður in 2011. The domestic operations of the firm had been transferred by the financial regulator to a new entity called Byr hf. which held deposits amounting to 130
billion ISK at year-end 2010 (Byr hf., 2011). Íslandsbanki’s financial statements for 2015 state that customer deposits constituted 56.7% of its total funding, as is shown in Figure 10 (Íslandsbanki, 2012).

Deposits due to the Central Bank and other credit institutions have all but disappeared, decreasing from 157 billion ISK in 2008 to 26 billion ISK in 2015. It is likely that a part of that decrease is the re-classification of Glitnir’s deposits, which went from being classified as credit institution to being a customer of the bank. According to its 2015 financial statements, Glitnir held at least 35 billion ISK as term deposits at Íslandsbanki, which alone exceeds the amount of deposits Íslandsbanki assigns to credit institutions (Glitnir HoldCo, 2016).

Íslandsbanki tried to slowly increase its borrowing since its founding in 2008, almost exclusively with collateralized, ISK denominated bond issues for the first few years. It wasn’t until 2014 and 2015 that Íslandsbanki substantially added to its borrowing, when the bank issued uncollateralized, foreign denominated bonds for a total just under 70 billion ISK, increasing its borrowing by 66% in the last two years. The bank’s cost of funding has steadily declined in the last year and the bank therefore refinanced and

![Íslandsbanki - Funding Composition - Proportional](image)
lengthened a portion of the Euro denominated bonds originally issued in 2014, lowering the interest cost on the debt by 12.5 bps.

Íslandsbanki’s equity has gone through some changes during the period but since 2008 it has doubled, from 10% to just under 20% of the bank’s total funding. As is stated earlier in this chapter the government supplied the bank with 775 million ISK in cash as starting capital in October 2008 but the total capital of the new bank was 65 billion ISK, since the government additionally pledged 64.2 billion ISK in governmental bonds. The bank issued 10 billion shares to the government instead, making the value of each share 6.5 ISK.

In accordance with an agreement made between Glitnir and the government in October 2009 Íslandsbanki transferred the government bonds, amounting to 64.2 billion ISK, to Glitnir. Glitnir subsequently delivered the bonds back to the government and instead took over 9.5 billion of Íslandsbanki’s shares. In addition to these transfers, the government agreed to extend a 10 year subordinated loan of 138 million Euros which by year-end 2015 was still on Íslandsbanki’s books.


Since 2009 the bank has turned a profit of 20 to 30 billion ISK a year with the exception of 2011, when Íslandsbanki took over Byr hf., the domestic operations of a failed savings and loans firm, and subsequently wrote down the value of the transferred assets by around 18 billion ISK (Íslandsbanki, 2012). A large portion of the profits realized over the
period originates from the discount given when the loan portfolio was originally transferred from Glitnir to Íslandsbanki in 2008 and 2009. These profits abled the bank to retain earnings and increase its capital ratios over the period, which in 2015 stood at 30%, far exceeding the Central Bank’s additional temporary capital requirements of a 15.5% capital ratio (CBI, 2016a). However, the additional requirements set by the FME have not been officially published but in its financial statements for 2015, Íslandsbanki estimates its minimum capital ratio to be 23%, in accordance with FME’s requirements.

Glitnir’s stability contributions and other mitigating actions on its behalf will have various effects on Íslandsbanki funding composition. The largest contribution by Glitnir was the delivery of its 95% share of Íslandsbanki to the Icelandic government. The agreement also stipulated that Glitnir would forgo a dividend payment before the delivery and in exchange receive a larger allowance to convert ISK assets to currency. After these transactions the Icelandic government held a 100% stake in Íslandsbanki through its holding company Icelandic State Financial Investments. At the time of this writing the government is still the sole owner of Íslandsbanki but possibilities concerning the sale of the bank will be looked at in the next chapter.

In order to ensure Íslandsbanki’s foreign denominated funding, Glitnir agreed to supply foreign currency term deposits to the bank, later to be converted into a Euro denominated bond issue. The total amount of this transaction of foreign currency will be equivalent to 35 billion ISK, increasing the bank’s foreign borrowing by 50% (Íslandsbanki, 2016). The term deposits, which Glitnir deposited in December 2015, have a two year maturity but Íslandsbanki has the right to convert the deposits into a bond during that term, in accordance with an internationally recognized long term bond issue program. The term deposits carry a rate of interest of EURIBOR with a 1% premium but the one year EURIBOR was just under 0% at the time of this writing in late March 2016 (Glitnir HoldCo, 2016; Euribor, 2016).

As an estimation, since this bond has not been issued at the time of this writing, the interest cost could be similar to the bank’s Euro denominated bond issue in 2015, costing the bank 2.875% in fixed rates. That issue was however only a three-year bond while the agreement between Glitnir and the government states that the new issue should have a three to five year tenor, possibly resulting in a higher interest rate with longer maturity.
(Glitnir HoldCo, 2016). As noted before in the analysis of Arion Bank’s funding, these bond issues carry higher interest rates than the deposits that the estates held before. In the case of Íslandsbanki, the cost of the deposits was around 1% in the early months of 2016. When or if the bank takes advantage of its conversion right, it might see the cost of these 35 billion ISK rise by at least 2% or around 700 million ISK in additional interest costs a year.

Glitnir also agreed to pay up and refinance the subordinated loan extended by the government to Íslandsbanki in 2009 for 20 billion ISK or 138 million Euros. It was initially agreed that the new subordinated loan should bear market interest rates and have a minimum tenor of ten years or until 2026 (Íslandsbanki, 2015a). However, according to Glitnir’s financial statements for 2015, the estate bought the bond from the government last year but it has not been refinanced as its maturity date is still stated as 2019 in Íslandsbanki’s financial statements for 2015. This refinancing would have extended the funding maturity by seven years.

According to Glitnir’s 2015 financial statements, the agreement concerning the estate’s stability contributions granted the estate the right to convert 75.4 billion ISK into Euros through the Central Bank in January and February 2016. This withdrawal of a large amount of cash and cash equivalent assets will have an effect on Íslandsbanki, given that Glitnir keep all of these domestic liquid ISK assets at the bank. Other things being equal, this transaction reduced the bank’s assets by the whole amount as it needed to sell assets to meet its obligation. This has also taken a large portion of the bank’s short term assets but in its financial statements for 2015 the bank’s assets with maturity of three months or less was a total of 359 billion ISK, with 73 billion ISK being directly available.

Other mitigating actions taken by the Glitnir estate did not affect Íslandsbanki as much as the actions described above. These other actions were the transferring of various assets to the Treasury, both direct and through cash sweep provisions.

### 3.3 Landsbankinn

In the last two years before the collapse LBI had collected deposits in some European countries, mainly the UK and the Netherlands, through branches which it had opened abroad. The British financial regulator was startled when the news started pouring out of Iceland about the planned governmental purchase of a large portion of Glitnir. A few days
later, when LBI had filed for governmental assistance and was subsequently taken over, the British were uncertain how the Icelandic government would handle LBI’s foreign deposits. To protect UK deposit holders, the British government froze all LBI’s assets in the UK, including the bank’s subsidiaries, on the basis of the so-called terrorist act. This would mark the beginning of a large legal battle, later called the Icesave dispute, between the Icelandic government on one side and on the other, the UK and Dutch governments.

After the Financial Supervisory Authority had taken over control of LBI, it promptly separated all domestic assets and liabilities to a new entity called NBI, later to be called Landsbankinn. Its funding composition in year-end 2008 is shown in Figure 13.

![Figure 13: Landsbankinn’s funding in year-end 2008. Source: Landsbankinn’s Consolidated Financial Statements, 2008.](image)

As in the case of Arion Bank and Íslandsbanki, the largest part of Landsbankinn’s funding came from customer deposits or a total of 42%. Since the assets transferred from LBI to Landsbankinn were significantly greater than the liabilities, Landsbankinn issued a bond, denominated in various foreign currencies, to LBI for the total amount. This transaction was booked more than a year after the initial transfer of assets and therefore could not be accounted to the initial date due to regulations. Instead it was booked as a provisional loan in the 2008 financial statements but later changed to a senior secured bond in Landsbankinn’s 2009 financial statements. The bank’s equity consisted of a 775 million ISK in cash and 121.2 billion ISK in government bonds delivered by the Icelandic government, which received an 81% stake in the bank. The remaining 19% of
Landsbankinn’s shares went to LBI which instead dropped claims which it had on Landsbankinn amounting to 28 billion ISK (MoF, 2011).

The bank’s total deposits have been relatively stable over the period, reaching a peak of roughly 600 billion ISK in 2013. In 2014, Landsbankinn began accounting LBI’s deposits as customer deposits and not as deposits due to credit institutions as it did before. In December 2014 the Central Bank granted LBI an exemption from the Foreign Exchange Act, allowing the estate to commence payments in the amount of 400 billion ISK to priority creditors (CBI, 2014).

It was not stipulated in the press release nor the estate’s financial statements what portion of the total amount was converted from ISK, if any, and what portion had been stored with Icelandic entities, such as Landsbankinn. However, Landsbankinn’s 2014 financial statement shows that LBI’s deposits at the bank decreased by 30 billion ISK during the year, indicating that a small portion of the 400 billion ISK might have originated in Landsbankinn. This agreement followed an amendment made to the bond issued by Landsbankinn to LBI during the bank’s founding, which will be discussed further below.

The fact that Landsbankinn issued a bond to LBI instead of equity meant that the bank’s borrowing was substantial from the beginning. The initial bond issued to LBI was
separated into three parts, each denominated in a specific currency, making it a foreign loan for Landsbankinn. Originally the bond principal was scheduled to be paid in 20 payments between 2014 and 2018, but in May 2014 Landsbankinn and LBI reached an agreement to refinance and lengthen the issue (Landsbankinn, 2014b). The total bond issues by the bank to LBI are shown in Table 3, both the balance before the refinancing of the loan and after.


<table>
<thead>
<tr>
<th>31.12.2013</th>
<th>Bond</th>
<th>Currency</th>
<th>Maturity</th>
<th>Balance</th>
<th>Rate</th>
<th>ISK balance in billions</th>
</tr>
</thead>
<tbody>
<tr>
<td>EUR Bond</td>
<td>EUR</td>
<td>9.10.2018</td>
<td>€ 775,000,000</td>
<td>EURIBOR + 2.90%</td>
<td>119.8</td>
<td></td>
</tr>
<tr>
<td>GBP Bond</td>
<td>GBP</td>
<td>9.10.2018</td>
<td>£ 241,000,000</td>
<td>LIBOR + 2.90%</td>
<td>45.9</td>
<td></td>
</tr>
<tr>
<td>USD Bond</td>
<td>USD</td>
<td>9.10.2018</td>
<td>$ 625,000,000</td>
<td>LIBOR + 2.90%</td>
<td>72.0</td>
<td></td>
</tr>
<tr>
<td><strong>Total bonds issued to LBI.</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td><strong>237.7</strong></td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>31.12.2014</th>
<th>Bond</th>
<th>Currency</th>
<th>Maturity</th>
<th>Balance</th>
<th>Rate</th>
<th>ISK balance in billions</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Bond B1</strong></td>
<td>EUR</td>
<td>9.10.2016</td>
<td>€ 99,000,000</td>
<td>EURIBOR + 2.90%</td>
<td>15.3</td>
<td></td>
</tr>
<tr>
<td><strong>Bond B2</strong></td>
<td>GBP</td>
<td>9.10.2016</td>
<td>£ 66,000,000</td>
<td>LIBOR + 2.90%</td>
<td>13.1</td>
<td></td>
</tr>
<tr>
<td><strong>Bond B3</strong></td>
<td>USD</td>
<td>9.10.2016</td>
<td>$ 18,000,000</td>
<td>LIBOR + 2.90%</td>
<td>2.3</td>
<td></td>
</tr>
<tr>
<td><strong>Bond C1</strong></td>
<td>EUR</td>
<td>9.10.2018</td>
<td>€ 132,000,000</td>
<td>EURIBOR + 2.90%</td>
<td>20.4</td>
<td></td>
</tr>
<tr>
<td><strong>Bond C2</strong></td>
<td>GBP</td>
<td>9.10.2018</td>
<td>£ 88,000,000</td>
<td>LIBOR + 2.90%</td>
<td>17.4</td>
<td></td>
</tr>
<tr>
<td><strong>Bond C3</strong></td>
<td>USD</td>
<td>9.10.2018</td>
<td>$ 24,000,000</td>
<td>LIBOR + 2.90%</td>
<td>3.0</td>
<td></td>
</tr>
<tr>
<td><strong>Bond D</strong></td>
<td>USD</td>
<td>9.10.2020</td>
<td>$ 271,000,000</td>
<td>LIBOR + 2.90% / 3.50%</td>
<td>34.4</td>
<td></td>
</tr>
<tr>
<td><strong>Bond E</strong></td>
<td>EUR</td>
<td>9.10.2022</td>
<td>€ 192,000,000</td>
<td>EURIBOR + 2.90% / 3.65%</td>
<td>29.6</td>
<td></td>
</tr>
<tr>
<td><strong>Bond F</strong></td>
<td>USD</td>
<td>9.10.2024</td>
<td>$ 271,000,000</td>
<td>LIBOR + 2.90% / 3.95%</td>
<td>34.4</td>
<td></td>
</tr>
<tr>
<td><strong>Bond G</strong></td>
<td>EUR</td>
<td>9.10.2026</td>
<td>€ 192,000,000</td>
<td>EURIBOR + 2.90% / 4.05%</td>
<td>29.6</td>
<td></td>
</tr>
<tr>
<td><strong>Total bonds issued to LBI.</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td><strong>199.6</strong></td>
<td></td>
</tr>
</tbody>
</table>

The lengthening of Landsbankinn’s debt was LBI’s first step toward meeting the stability conditions, which had not been made official at that time. Instead of the whole

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4 Already prepaid bonds at year-end 2015 are distinguished with italics in Table 3.
In addition to these bond issues, Landsbankinn agreed to issue a Euro denominated contingent bond to LBI, due to an asset portfolio which had an uncertain recovery. The principal of the bond was contingent on the value of these assets over a certain period, with an upper limit equivalent to 92 billion ISK. LBI agreed to relinquish its share in Landsbankinn if the contingent bond reached this maximum value, which it did at the end of the period in 2012 (MoF, 2011). This meant that the Icelandic government had become the sole owner of Landsbankinn, excluding a 2.1% share held by the bank itself and its employees.


The bank’s equity has grown steadily as it has been forced to retain most of its earnings due to restrictions on dividend payments, resulting in equity amounting to 265 billion, equivalent to 23.6% of the bank’s assets. Those dividend restrictions were lifted in the 2014 agreement concerning the refinancing of the bank’s bonds issued to LBI.
(Landsbankinn, 2014c). As shown in Figure 16, the bank has seen profits ranging from around 15 to over 35 billion ISK, excluding the first year when the bank reported losses of 7 billion ISK, mostly due to acquisition of assets from LBI (Landsbankinn, 2009). During the first two years, the bank struggled to reach the additional requirements set by the Financial Supervisory Authority, requiring the bank to maintain a 16% CAD ratio (Landsbankinn, 2011). The bank reached that minimum in 2010 and has increased its capital adequacy ratio since to roughly 30% in year-end 2015, far exceeding even the additional 5% buffer recommended by the Central Bank in January 2016 (CBI, 2016a).

![Landbankinn's Profits and Capital Ratios](image)

**Figure 16: Landbankinn's capital ratios from 2008 – 2015. Source: Landbankinn’s Consolidated Financial Statements, 2008 – 2015.**

Of the contributions and mitigating actions taken by LBI to fulfil the stability conditions set by the Central Bank and the Ministry of Finance, only the refinancing will have a considerable impact on Landbankinn’s future funding. Due to the refinancing, the bank has stable long term foreign funding until 2026, instead of a major part of its funding having a maturity in 2018. Additionally, Landbankinn has the option to convert the bonds through the bank’s EMTN program if market conditions are favorable. This might lower the bank’s ratio of collateralized funding, since the current bonds have a collateral requirement of a 115%.

With the refinancing in 2014, the LBI estate had already met the largest part of the conditions set to avoid the negative impact on the balance of payments due to its
settlement. Other contributions were assets amounting to 23 billion ISK, almost exclusively in ISK assets (CBI, 2015b).
4 What will be the effect on the money supply?

In 2003 the Central Bank of Iceland decided to reduce the reserve requirements of Icelandic banks from 4% to 2%, stating it was necessary in order for the banking system to stay competitive in international markets (CBI, 2003). According to classic economic theories, this decrease of reserves could lead to a twofold increase in the money supply in the Icelandic economy, which subsequently happened between the years 2003 and 2007\(^5\). In the fall of 2007, when the first signs of financial difficulties started to emerge, the Central Bank lowered the standard of quality of the collateral it required against liquid loans to the Icelandic banks. This change made it possible for the banks to pledge their own bonds at the Central Bank and receive loans of Central Bank reserves instead. In the following year the money supply increased by around 100% due to these loans, meaning that nominal money supply had quadrupled over a five year period. The majority of the money created in the years prior to the collapse of the banks still resides in the system and this chapter will focus on what effects the stability contributions will have on the money supply.

There are always some changes in the money supply due to the devaluation of the currency, also known as inflation. The demand for money on hand rises when the price level in the economy has increased. Therefore, it is more appropriate for this analysis to look at real changes in money supply instead of nominal ones and to accomplish that the money supply (M3) is described as a percentage of the gross domestic product (GDP) of Iceland, as seen in Figure 17.

The relative number of money supply indicates the depth of the economy’s financial markets as can be inferred by the peak of the ratio around the year 2008. A currency’s ability to store value can also be interpreted from the ratio, M3 over GDP. If the ratio is high in any economy, even higher than 100%, that might indicate a demand for the currency in order to store value. There are mainly large currencies, such as the US Dollar and the Euro, which can operate in this way but the Icelandic Krona does not fulfil the requirements needed to act as a store of value. Consequently, virtually all of the roughly

\(^5\) In this text money supply is used to refer to what is sometimes called M3 in economic literature. M3 is the total of all cash (in circulation), bank deposits and money market funds in the economy.
250% increase in real money supply in Iceland prior to the crash in 2008 went straight back into the financial system (Jónsson and Sigurgeirsson, 2015).

![Money supply (M3) relative to GDP](image)

**Figure 17**: Money supply (M3) relative to Iceland’s GDP from 1995-2015. Source: Annual Reports from the Central Bank of Iceland, 1995-2015.

When the banks collapsed in 2008 the Central Bank of Iceland had outstanding collateralized loans to the banking system amounting to 345 billion ISK. The collateral against these loans was mostly bonds from the old banks themselves which had fallen behind in claim priority, due to the Emergency Act making deposits a priority claim. At year-end 2008 the estimated recovery of the collateral was 95 billion ISK which meant the assets had to be written down by 250 billion ISK due to depreciation. Instead of the Central Bank taking the total loss on its books, it wrote the loan down by 75 billion ISK and sold it to the Icelandic Treasury for 270 billion ISK, which wrote it down by 175 billion ISK\(^6\). The Treasury paid for the transaction with a special government bond issue which had a maturity in 2015 and came to be known as the “Central Bank bond”.

The initial claims were transferred back in 2010, along with some additional claims acquired by the Treasury, to the Central Bank’s newly established holding company, ESÍ. The estimated recovery of the total claims was at the time 134 billion ISK and the “Central Bank bond” was marked down by the same amount. Since then the terms of the bond have been renegotiated and the bond now has a maturity in 2043 with scheduled yearly

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\(^6\) This was done to maintain positive equity in the Central Bank.
payments but is also callable by the Treasury at any time. Relatively small principal payments were made in the first years but in 2014 and 2015 the Treasury made principal payments of 26 billion ISK and 50 billion ISK, respectively, which resulted in a 90 billion ISK year-end principal of the bond (Jónsson and Sigurgeirsson, 2015; Government Debt Management, 2016a).

The balance of the “Central Bank bond”, along with a vast amount of deposits in the banking system, represents the increase in money supply during the years before the financial crash. In its 2016 budget the government has laid out a plan to pay up the remaining principal of the bond by the end of the year with the proceeds from the stability contributions. The Treasury has already paid 25 billion ISK into a special account at the Central Bank created for these proceeds, which will later be used to pay down the bond (Government Debt Management, 2016b). This chapter will focus on how various actions taken by the estates through their fulfilment of the stability conditions will affect the money supply.

4.1 Bank equity
The single largest contribution from the estates was Glitnir’s delivery of its share in Íslandsbanki to the government, estimated at 185 billion ISK. Since delivery of the shares, the Icelandic government is the sole owner of Íslandsbanki but the transaction does not affect the money supply directly. There are roughly two scenarios possible for the government to allocate its share in Íslandsbanki. The first is to sell the government’s stake in the bank, either to domestic or foreign investors, which would decrease the money supply given that the payment would be made in cash or cash equivalent assets, which would not originate as loans from other loaning institutions.

The second possibility is for the government to keep its shares in Íslandsbanki and pay out the bank’s retained earnings from the last years as dividend. In Íslandsbanki’s financial statements for 2015 the board recommends that 50% of the year’s profits will be paid out as dividend or a total of 10 billion ISK. Additionally, the bank has increased its equity considerably over the years, enabling the bank to pay 40 billion ISK more as dividend or 50 billion ISK total, without reducing its capital adequacy ratio below 23%, which is the minimum recommended by the Central Bank and FME. If Íslandsbanki pays dividend to
the Treasury it decreases money supply and therefore both possibilities offer the government an opportunity to take considerable amounts out of circulation.

\[ \text{Figure 18: The change in the banks' capital ratios with dividend payments. Source: Consolidated Financial Statements from Arion Bank, Íslandsbanki and Landsbankinn, 2015.}^7 \]

The government has also held a 97% share in Landsbankinn ever since the bank’s contingent bond to LBI was paid in full in 2012. Therefore the same possibilities arise for the government to either sell the share or hold it and pay out dividend to the Treasury. In the bank’s financial statements for 2015 the board recommends that 28.5 billion ISK or 78% of the year’s profits should be paid as dividend. Landsbankinn is able to pay additional 35.5 billion ISK in dividend without the bank’s capital adequacy ratio falling under 23% or a total dividend payment of 64 billion ISK. That being the case, the government, through its ownership in the two banks, could pay out a total of 114 billion ISK as dividend and still maintain the required capital ratios.

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7 Both the lower 18% minimum set by the FME and the new increased 23% minimum on capital ratios are estimated by Íslandsbanki’s 2015 Financial Statements. It is estimated to be the upper limit of the requirements set by the FME on the banks, but the FME does not publish these numbers officially.
In the case of Arion Bank the government’s share of the equity is 13% but as a part of the stability contributions Kaupthing has issued a bond with a principal of 84 billion ISK and an attached profit sharing agreement estimated at 20 billion ISK or a total of 104 billion ISK. The bond is only payable with proceeds from the sale of Arion Bank which will deliver the total amount to the Treasury, decreasing the money supply by the same amount. It is not dependent on whether the future investors in Arion Bank are foreign or domestic but the total effect on the money supply relies more on the origin of the funds within the system, whether they come from cash equivalents or from assets with a longer maturity. Arion Bank’s capital ratio is not as high as the ratios of the other two banks, resulting in the board recommending that no dividend is to be paid out in 2016 (Arion Bank, 2016).

4.2 Other actions
Other assets delivered to the Treasury as stability contributions from the estates had an estimated worth of 91 billion ISK, with 14 billion ISK of that amount in foreign denominated assets. These assets vary in level of liquidity, from cash to large stakes in domestic companies, but if converted into cash through a selling process they would decrease the money supply by the total amount realized. Additionally, the Treasury received 31 billion ISK in taxes and bank levies from the estates for the year 2015, which also reduced the amount of money in circulation.

The claims which were initially held by the Central Bank due to the loans made to the banking system prior to the crash were later moved to the bank’s holding company, ESÍ. The recovery of the claims was estimated at 90 billion ISK in 2015, with foreign funds equivalent to 69 billion ISK being paid between 2016 and 2019. When those funds reach the Central Bank they will either decrease the money supply, if converted into ISK, or strengthen the foreign currency reserves of the bank. Since these recoveries are expected to be realized over three or more years, the effects on the money supply will also be spread over that period.

Other actions taken by the estates which will affect the money supply are the repayments of loans on behalf of the new banks. Glitnir bought a subordinated bond from the Treasury, issued by Íslandsbanki, for 138 million Euros, equivalent to 20 billion ISK. Kaupthing bought a collateralized bond from the Central Bank, issued by Arion Bank, for
a total of 430 million Euros, equivalent to 56 billion ISK. As stated earlier in this paper, the estates agreed to refinance these bonds in order to lengthen the maturity on the banks’ liability side. The repayment of the bonds to the government amounts to 76 billion ISK in foreign currency which will either increase the Central Bank’s currency reserves or decrease money supply, if the currency is converted into ISK cash.

Additionally, Glitnir and Kaupthing agreed to convert their foreign deposits into bonds with longer maturity and the conversion of deposits amount to 77 billion ISK in foreign currency. This will decrease the deposits held by Íslandsbanki and Arion Bank by 35 and 42 billion ISK, respectively, and therefore reduce the money supply as well.

However, the longer maturity of the banks’ liabilities creates an opportunity for increased lending since their liquidity ratios have improved and their maturity mismatch has been reduced. Liquidity ratio is a measure of an entity’s capability to meet its short term liabilities and the maturity mismatch is a fundamental problem which stems from banks mainly lending money for the long term but financing themselves with short term deposits. With these financial metrics improving at Íslandsbanki and Arion Bank, the banks have a greater opportunity to increase their lending operations since these metrics might have limited their ability to grow. If the banks increase their lending operations as a result of these changes, the money supply would first increase by the amount lent and possibly increase more over time, due to the effects described by the money multiplier.

In their agreement with the government, two of the estates, Kaupthing and Glitnir, received an allowance to convert ISK cash to foreign currency. Glitnir, receiving a larger allowance for delivering its share in Íslandsbanki, is allowed to exchange 72 billion ISK while Kaupthing is allowed to exchange 46 billion ISK. When the estates use this allowance, the Central Bank will recover the ISK assets and reduce the money supply. This transaction has however already been offset by the Central Bank’s purchase of currency and foreign denominated assets for ISK, which in 2015 alone amounted to 272 billion ISK (CBI, 2016c).
Figure 19: Changes in money supply due to stability contributions and other mitigating actions taken by the estates. The percentages indicate the money supply (M3) relative to Iceland’s 2015 GDP.

Source: Central Bank of Iceland, 2015a.

All stability contributions and other mitigating actions taken by the estates which might affect the money supply are shown in Figure 19. If the Treasury and the Central Bank were to use every opportunity to reduce the money stock they could decrease it by over 700 billion ISK. As was noted earlier the magnitude of the effects to the money supply relies on how the Treasury allocates the funds it receives but it also relies on the reaction of the commercial banks. If the banks decide to use the opportunity to expand their lending operations they might increase the money supply and offset any decrease made by the Treasury. This effect might be compounded if the banks were to lend investors capital for the purchase of each other, but that is exactly what happened in 2003 when the Icelandic government privatized the banking system (Hreinsson, Gunnarsson and Benediktsdottir, 2010).

The Central Bank and the Ministry of Finance and Economic Affairs have been working on ridding the country of the capital controls put in place after the financial crisis in 2008. The government has taken various measures to prepare the Icelandic economy for the elimination of the controls in order to reduce the risk of financial instability. These measures evidently include the stability contributions and other mitigating actions taken...
by the estates, which have been analyzed in this paper. But among other actions taken as a preparation was the Central Bank’s purchase of vast amounts of foreign assets over the last years. The Central Bank has been forced to strengthen its foreign reserves but its accumulated net purchase of foreign assets from 2010 to 2015 amounted to 380 billion ISK, thereof a net purchase of a 123 billion ISK purchase in 2015 alone. In year-end 2015 the Central Bank’s total foreign reserves amounted to 653 billion ISK (CBI, 2015b; CBI, 2016c). A strong reserve is a fundamental tool for the Central Bank to maintain stability and to increase the merit of its monetary policies but it also requires the bank to forfeit ISK assets. When the Central Bank purchases foreign assets, either from domestic or foreign entities, it pays for the transaction with ISK assets, either with cash or other assets with a longer maturity. These assets, which all mature to cash at some point, increase ISK in circulation, while the Central Bank simultaneously works on retrieving the excess money in the system back to its vaults.

This conundrum arises because the pressure on the government to abolish the capital controls does not only come from foreign entities in Iceland, such as the estates, but also from domestic investors. To maintain proper risk and portfolio management, Icelandic investors require a portion of their assets to be foreign denominated, but the capital controls have ruled out the possibility of renewing those investments. Subsequently, when the capital controls are lifted, both Icelandic and foreign investors will rush to the foreign currency market requiring the Central Bank to hold a large amount of reserves to prevent the collapse of the ISK currency. The bank might therefore reverse some of the increase in money supply due to its purchases of foreign assets in recent years when the capital controls are lifted.

The increased amount of money in the system still poses a threat to the balance of payments and the financial stability of the country. If the government intends to eliminate the capital controls which were set in late 2008, it has to maintain and minimize the risk associated with the flow of capital from the country. This relies on the Central Bank maintaining a responsible monetary policy and the Treasury to forgo spending the money gathered through the contributions.
5 Conclusion

The agreement on the stability contributions between the government and the estates stipulated that a total of eight estates were to deliver a total of 387 billion ISK to either the Treasury or the Central Bank. The largest two contributions were Glitnir’s share in Íslandsbanki and Kaupthing’s bond issue to the government, totaling 289 billion ISK. Furthermore, Glitnir and Kaupthing agreed to purchase foreign denominated bonds from the government for 74 billion ISK but these funds were granted to Íslandsbanki and Arion Bank in their early stages. In addition, the estates paid 31 billion ISK in taxes to the Treasury for the year 2015 which reduced the risk to financial stability arising from their domestic assets. In the coming years the Central Bank’s holding company, ESÍ, is expected to recover a total of 99 billion ISK through its claims on the estates, mostly in foreign currency. The total amount of assets received by the government will therefore be 517 billion ISK or the equivalent to 23.4% of the country’s 2015 GDP.

Table 4: Total contributions from all eight estates. Source: Central Bank, 2015.

<table>
<thead>
<tr>
<th>Amounts in ISK billions</th>
<th>All estates</th>
<th>% of GDP</th>
</tr>
</thead>
<tbody>
<tr>
<td>Direct contributions</td>
<td>387</td>
<td>17.5%</td>
</tr>
<tr>
<td>Indirect contributions</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Repayments</td>
<td>74</td>
<td>3.4%</td>
</tr>
<tr>
<td>Taxes</td>
<td>31</td>
<td>1.4%</td>
</tr>
<tr>
<td>ESÍ recoveries</td>
<td>99</td>
<td>4.5%</td>
</tr>
<tr>
<td>Total indirect contributions</td>
<td>204</td>
<td>9.3%</td>
</tr>
<tr>
<td>Total contributions</td>
<td>591</td>
<td>26.8%</td>
</tr>
</tbody>
</table>

The operation of winding up the old estates is unprecedented and it will likely have some major effects on the economy. The scope of all the actions taken by the estates, including their deposit conversions, is vast, amounting to 40.2% of Iceland’s 2015 GDP. Whether the final outcome for the economy will be positive or negative depends on the actions taken by the domestic institutions, both government and private, in the near future.

Arion Bank, Íslandsbanki and Landsbankinn, the three big Icelandic commercial banks, are affected by the winding up of their predecessors but there are also new opportunities
on the horizon. The increase in long term foreign bonds held by the banks along with their high equity ratios opens up the possibility of expansion. The conversion of deposits to long term bonds both improves the banks’ liquidity ratios and decreases their maturity mismatch. By improving those metrics the banks have a better position to increase their lending operations and expand. However, these conversions are likely to increase the total funding costs for the banks since deposits generally bear lower interests than bonds. Any additional deposits from the estates held at the banks will not remain there for long and will likely be used to pay the estates’ creditors. The average funding cost of the banks will increase, at least in the short term but the possibility of a better credit rating might offset the increase in the future.

Another possibility is for the banks to pay out dividend to their owners and thereby decrease their total size instead of focusing on expansion. However, it must be taken into account that the government holds virtually all shares in both Íslandsbanki and Landsbankinn. The government has issued statements on its intentions to sell the banks but it is not clear whether it would pay out dividend to itself first, to recover the accumulated equity. Therefore there are many different possibilities on the horizon and paths which the banks and their owners can take to change the funding composition in the coming years.

The amount of assets already delivered to the Treasury and the amount of assets it will receive in the next few years is certainly large enough to have a major effect on the money supply but it all depends on how the government decides to allocate the funds. As was noted in the last chapter the government has an opportunity to reduce the money stock by as much as 700 billion ISK which would reduce the money supply from being 78.1% of GDP down to 43.3%. Both the Ministry of Finance and the Central Bank have stated the importance of paying down the Treasury’s debt but to what extent they will is not certain. With such vast amounts it is likely that the Treasury will call back some of its outstanding bonds but at the same time the government might be tempted to use a portion of the funds to increase its spending.

In a report issued on March 21, 2016, the Ministry of Finance laid out two main uses for the revenue stemming from the stability contributions. Firstly, the contributions are to fill the gap in governmental spending, created from the loss of special tax revenue from
the estates. This means that the Ministry of Finance intends to use some amount of the contributions to plug the holes in its budget but how large that amount will be is uncertain. Secondly, the Ministry states the importance of paying down the Central Bank bond in order to prevent the increase in money supply and the risk it would pose to financial stability (MoF, 2016). These statements might fit well to the amounts the Treasury has recovered or will recover in the next months but the total amount which will be delivered to the Treasury is much greater. Therefore, the Treasury does not appear to have a long term plan for the funds it will acquire from the sale of large assets, for example the sale of its shares in the banks.

The Treasury has been repaying its debt to the Central Bank for several years but the principal of the bond was 90 billion ISK in year-end 2015. On March 1, after the delivery of some of the stability contributions, the Treasury paid down the Central Bank bond by 25 billion ISK, lowering the principal to 65 billion ISK. The Treasury has further vowed to fully pay down the bond in the fiscal year of 2016 but what other bonds, if any, the Treasury might pay down as well has not been stated (CDM, 2016b).

The effects of the stability contributions on the money supply will ultimately be decided by the allocation of the funds. With parliamentary elections being held either in the fall of 2016 or in the spring of 2017, there is a risk of political manipulation and promises concerning these future revenue streams to the Treasury. A strong and independent Central Bank is fundamental in this situation to guide the political powers in these matters and to caution imprudent actions by the elected government, in order to secure the financial stability of the Icelandic economy.
References


